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IN THE

Supreme Court of the United States

October Term, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

On Appeal From the Court Of Appeal of the State of California, First Appellate District

BRIEF OF AMICUS CURIAE STATE OF VERMONT IN SUPPORT OF BRIEF OF FRANCHISE TAX BOARD

JOHN J. EASTON, JR.
Attorney General
State of Vermont
PAUL P. HANLON
Deputy Commissioner and General Counsel
Vermont Department of Taxes
P. O. Box 694
Montpelier, Vermont 05602
Tel. No. 802-828-2805
Counsel for Amicus Curiae

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STATEMENT OF INTEREST

At stake for Vermont is a substantial reduction in tax revenues. A decision in support of Container Corporation of America ("Container") would overrule this Court's decision in favor of Vermont in *Mobil Oil Corporation* v. *Commissioner of Taxes,* 445 U.S. 425 (1980), by holding that income of a foreign subsidiary can be excluded from a parent company's apportionable tax base solely because the subsidiary income is characterized as having a foreign source.

Furthermore, acceptance of the position advocated by Container would require Vermont to rely upon what is commonly referred to as the "arm's-length standard," a method of accounting that requires intercompany transactions to be priced like transactions between unrelated parties. This method is expensive and imposes significant administrative burdens on both taxpayers and tax administrators. COMPTROLLER GENERAL, REPORT TO THE CHAIRMAN, HOUSE COMM. ON WAYS AND MEANS 52-53 (Sept. 30, 1981); HOUSE COMM. ON WAYS AND MEANS, H.R. DOC. No. 788, 95th Cong., 1st Sess., RECOMMENDATION OF THE TASK FORCE ON FOREIGN SOURCE INCOME (Comm. Print 1977). It is virtually impossible for a small state like Vermont to reconstruct intercompany transactions on a worldwide arm's-length basis.

Because Vermont would be unable to enforce the arm's-length method of accounting, it would be unable to guard against misallocation of income by multinational corporations operating in Vermont. A decision that allocation of foreign source income is constitutionally required would force Vermont to discriminate in its tax enforcement policies against wholly domestic corporations, which would report their income using only formulary accounting. As a result, a real danger exists that these corporations would bear a disproportionate share of the tax burden in Vermont.

INTRODUCTION AND SUMMARY OF ARGUMENT

The Commerce Clause does not prohibit a state from taxing the net income of a corporation solely because the income has a foreign source. A state may constitutionally tax the combined net income of a domestic corporation and its foreign unitary subsidiaries if the income is fairly apportioned to reflect the business' activities within the taxing jurisdiction.

An inherent conflict exists between the revenue needs of the states and the national interest in encouraging the free flow of commerce among the states and between this country and other countries. Recognizing this conflict, this Court has stated that

> [A] State has a significant interest in exacting from interstate commerce its fair share of the cost of state government. 430 U.S., at 288. Accord, *Colonial Pipeline Co.* v. *Traigle*, 421 U.S., at 108; *Western Live Stock* v. *Bureau of Revenue*, 303 U.S., at 254. All tax burdens do not impermissibly impede interstate commerce. The Commerce Clause balance tips against the tax only when it unfairly burdens commerce by exacting more than a just share from the interstate activity.

Washington Revenue Department v. Stevedoring Association, 435 U.S. 734, 748 (1978). State taxes on net income derived from interstate or foreign commerce have been held constitutional when they are fairly apportioned to reflect business activities in the taxing jurisdiction. *E.g.*,

Northwestern Cement Co. v. *Minnesota*, 358 U.S. 450 (1959); *Norfolk & Western Railway* v. *North Carolina*, 297 U.S. 682 (1936); *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U.S. 271 (1924).

Container has argued that worldwide apportionment of net income derived from a unitary business violates the Commerce Clause because it results in multiple taxation of foreign source income. In Container's view, the Commerce Clause requires allocation of foreign source income, rather than apportionment. Container's argument rests on a series of erroneous premises:

(1) that California's efforts to tax a fairly apportioned share of a business' net income should be treated as an attempt to tax foreign income;

(2) that California's tax results in multiple taxation;

(3) that the Commerce Clause prohibits overlapping in taxation arising from differences in accounting methods among nations;

(4) that this Court's decision in *Japan Line, Ltd.* v. *County of Los Angeles* requires allocation of foreign source income; and

(5) that the Court would be without power to prevent excessive taxation of income derived from foreign commerce should it arise.

ARGUMENT

There is no Commerce Clause bar to a fairly apportioned tax on the combined net income of a domestic corporation and its foreign unitary subsidiaries.

A. California's tax on a fairly apportioned share of the net income derived from a unitary business is not a tax on "foreign" income.

Two basic accounting methods are employed by tax officials to ensure that income is taxed only in the jurisdiction where it is earned. One method, separate accounting, attempts to identify the sources of net income generated by a business and to allocate to each situs the income earned in that situs. The other method, unitary apportionment, attempts to allocate net income to each locality in which a business operates in the proportion that the business activities conducted by the corporation in that locality bears to the business activities conducted by the corporation in all localities.

This Court has stated that separate accounting is not constitutionally required. In *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425 (1980), the Court rejected the contention that the source of income earned by a unitary business must be ascertained by separate geographic accounting.

> [S]eparate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and

> economies of scale. *Butler Bros.* v. *McColgan*, 315 U.S., at 508-509. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source." Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required.

445 U.S. at 438.

As the Court stated in *Mobil*,

> [T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle.

445 U.S. at 439. This statement was repeated by the Court in *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 223 (1980) and *Asarco, Inc. v. Idaho State Tax Commission*, . . . U.S. . . . , 50 U.S.L.W. 4962 (U.S. June 29, 1982). In keeping with these decisions, a state may constitutionally tax the entire net income of a corporation and its subsidiaries, foreign and domestic, if the corporations form a unitary business and the net income is fairly apportioned to reflect business activities within the taxing jurisdiction.

The Court recognized that foreign source income may be included in an apportioned tax base in *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924). The Court concluded that although a British corporation had attributed its income entirely to foreign

sources for federal income tax purposes, New York could tax that allegedly "foreign" income on a fairly apportioned basis because the corporation carried on sales activities there as part of its unitary business. The same conclusion should be drawn in this case.

California's taxing plan reaches only income that fairly represents the extent of the business activities of Container and its unitary subsidiaries within the State of California. *Butler Brothers v. McColgan*, 315 U.S. 501, 506 (1942). California has not gone beyond its borders to tax the entire net income of the corporation or the separate income of its subsidiaries. The fact that earnings of Container's foreign subsidiaries are included in California's apportionable tax base does not make the tax one on foreign commerce.

> [F]oreign source income is no different from any other income when it comes to determining, by formulary apportionment, the appropriate share of the income of a unitary business taxable by a particular state. This does not involve state taxation of foreign source income any more than does apportionment — in the case of a multistate business — involve the taxation of income arising in other states. In both situations the total income of the unitary business simply provides the starting point for computing the instate income taxable by the particular state.

Rudolph, *State Taxation of Interstate Business: The*

Unitary Business Concept and Affiliated Corporate Groups, 25 TAX L. REV. 171, 205 (1970).

B. California's apportioned tax does not result in multiple taxation.

The Court has rejected speculation on the question of multiple taxation, requiring instead actual proof of duplicative taxation. *E.g., Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 228-29 (1980); *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 276 (1978); *Northwestern Cement Co. v. Minnesota*, 358 U.S. 450, 462 (1959). Absent clear and cogent evidence to the contrary, an apportioned tax is recognized as avoiding multiple taxation.

> The apportioned tax is designed to meet this very requirement and "to prevent the levying of such taxes as will discriminate against or prohibit the interstate activities or will place the interstate commerce at a disadvantage, relative to local commerce." *Id.*, at 670. Logically it is impossible, when the tax is fairly apportioned, to have the same income taxed twice.

Northwestern Cement Co. v. Minnesota, 358 U.S. 450, 462 (1959).

Container has attempted to establish that multiple taxation occurs under California's tax by comparing the results of separate accounting with the results of California's apportionment formula. The actual comparison used failed to account for variations in the definition of

"income" for tax purposes from jurisdiction to jurisdiction. Absent proof that the taxing jurisdictions employed the same tax definition of "income," a comparison of accounting methods does not show that multiple taxation in fact occurred.

C. The Commerce Clause permits some overlapping in taxation.

Even if Container were able to establish that multiple taxation in fact had occurred, this Court has never invalidated a properly apportioned state income tax solely because some overlap in taxation arose out of differences in accounting methods employed among taxing jurisdictions. In *Moorman Manufacturing Co. v. Bair*, 437 U.S. at 278 (1978), the Court noted that some risk of duplicative taxation exists whenever the states in which a corporation does business do not follow identical rules for the division of income. The Court nevertheless refused to legislate uniform rules for the division of income. Again in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 455 (1979), the Court stated that mathematical imprecision in apportionment formulae does not invalidate a fair apportionment scheme.

> [T]his Court consistently had held that the Commerce Clause "does not call for mathematical exactness nor for the rigid application of a particular formula; only if the resulting valuation is palpably excessive will it be set aside." (citations omitted).

A decision that a fairly apportioned net income tax may not be imposed because of differences in accounting methods employed among nations would allow corpora-

tions to avoid their fair share of taxes without justification. Because the Court would be without jurisdiction to regulate the taxing schemes of foreign countries, a requirement that California's fair apportionment formula must yield to the allocation made by a foreign government would render California impotent to exact from multinational commerce its share of the cost of government.

The appropriate question for this Court is whether California's tax scheme results in a fair allocation of the tax burden among all states and countries in which a unitary business operates, not whether mathematical precision in taxation is attained. As the Court has done in the case of multistate businesses, the Court should sustain state income taxes on multinational corporations provided the taxes meet the four requirements described in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The Court should sustain taxes, like California's, that are applied to activities with a substantial nexus with the state, that are fairly apportioned, that do not discriminate against foreign commerce, and that are fairly related to the services provided by the state. 430 U.S. at 279.

D. The Court's decision in *Japan Line, Ltd.* has no application to this case.

In the context of ad valorem taxation of instrumentalities of foreign commerce, the Court imposed two tests in addition to those articulated in *Complete Auto Transit. Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979). The Court required that the tax not result in multiple taxation of the instrumentalities of foreign commerce and that it not prevent the nation from "speaking

with one voice" when regulating foreign commerce. 441 U.S. at 451-52.

This Court's decision in *Japan Line* is not applicable to an apportioned income tax. *Japan Line* did not involve a net income tax properly apportioned to reflect activities within a state, but an *ad valorem* property tax levied directly on foreign-owned cargo containers used exclusively as instrumentalities of foreign commerce. The Court specifically noted that:

> The question here is a . . . narrow one, that is, whether instrumentalities of commerce that are owned, based, and registered abroad and that are used exclusively in international commerce, may be subjected to apportioned ad valorem property taxation by a State.

441 U.S. at 444. As the Court noted in *Mobil*, the principles of income taxation are different from those of property taxation.

> Appellant's attempted analogy between this case and *Japan Line* strikes us as forced. That case involved ad valorem property taxes assessed directly upon instrumentalities of foreign commerce. As has been noted, the factors favoring use of the allocation method in property taxation have no immediate applicability to an income tax.

445 U.S. at 448. *Accord, Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 228 (1980). The

additional tests set forth in *Japan Line* are therefore not applicable in this case.

Even if this Court finds that the additional tests set forth in *Japan Line* must be satisfied by an income tax, however, the factors that concerned the Court in *Japan Line* are not present in this case. First, no state or country has taxed 100% of the income of Container and its unitary subsidiaries. In *Japan Line*, the containers on which the County of Los Angeles sought to impose an apportioned property tax had already been subjected to a lawfully imposed tax on their full value in Japan. The levying of even an apportioned tax in the United States therefore ensured that the company would be paying a double tax on the containers. No similar double taxation occurred in this case because each state and country in which Container or its subsidiaries conducted business taxed only so much of the income of the business as was earned within its taxing jurisdiction.

Second, the imposition of an apportioned income tax does not prevent the nation from "speaking with one voice" when regulating foreign commerce. 441 U.S. at 451-52. In *Japan Line*, the county's *ad valorem* tax on containers frustrated a national policy, expressed in a Customs Convention on Containers that was signed by the United States and Japan, of removing all impediments to the use of containers as instruments of international traffic. 441 U.S. at 453. No similar conflict between federal and state policy exists in this case. Both the United States and the State of California tax foreign subsidiaries of domestic corporations on income earned within their taxing jurisdiction; only the accounting method employed to identify that income differs. Moreover, California's apportionment formula is consistent

with the treatment afforded to Container in other countries because each jurisdiction in which the business operated taxed only income earned in that jurisdiction.

2. This Court has the power to prevent excessive taxation of income should it arise.

Container's Commerce Clause argument assumes that this Court would be powerless to prevent excessive taxation of income in cases where it is shown to exist. This is not so. The Court stated in *Mobil* that:

> [A]ppellant's argument underestimates the power of this Court to correct excessive taxation on the field where appellant has chosen to pitch its battle. A discriminatory effect on foreign commerce as a result of multiple state taxation is just as detectable and corrigible as a similar effect on commerce among the States. Accordingly, we see no reason why the standard for identifying impermissible discrimination should differ in the two instances.

445 U.S. at 447. If California had exacted an excessive tax, the Court could correct the error by requiring California to alter its apportionment formula. For example, the Court could require California to exclude or modify any or all of the factors in its formula or to include one or more additional factors in order to accomplish an equitable apportionment of the business' income.

CONCLUSION

The Commerce Clause does not require allocation of foreign source income of a unitary business. California's tax on the combined net income of Container and its foreign unitary subsidiaries is constitutional because the income is fairly apportioned to reflect activities of the unitary business in California.

Container has not established that actual duplication in taxation resulted from California's apportioned tax. If an overlap in taxation did occur, it resulted from differences in accounting methods used by nations to determine the source of income and did not result from excessive taxation by California. California's apportionment formula need not yield to the allocation made by a foreign government because the apportionment resulted in a fair allocation of tax obligations. If burdensome duplication had resulted from California's tax, the appropriate mandate of this Court would be an adjustment of California's apportionment formula and not allocation of foreign source income.

Dated at Montpelier, Vermont this 28th day of September, 1982.

Respectfully submitted,

JOHN J. EASTON, JR.
Attorney General of Vermont
PAUL P. HANLON
Deputy Commissioner and General Counsel
Vermont Department of Taxes
P. O. Box 694
Montpelier, Vermont 05602
Counsel for Amicus Curiae

CERTIFICATE OF SERVICE

I hereby certify that on this 28th day of September, 1982, three copies of this brief were mailed, with first class postage prepaid, to Franklin C. Latcham, Morrison & Foerster, One Market Plaza, Spear Street Tower, San Francisco, California 94105, Counsel for Appellant, and to George Deukmejiian, Attorney General, and Neal J. Gobar, Deputy Attorney General, 110 West A Street, Suite 700, San Diego, California 92101, Counsel for Appellee. I further certify that all parties required to be served have been served.

PAUL P. HANLON
Deputy Commissioner and General Counsel
Vermont Department of Taxes
P. O. Box 694
Montpelier, Vermont 05602

Counsel for Amicus Curiae